

June 9, 2014

## **Outsourcing Investment Services That Named Fiduciaries Have Traditionally Performed**

Thank you for inviting me to appear before your Council on the trend and implications of named fiduciaries outsourcing investment functions they themselves have typically performed.<sup>1</sup> In preparing my remarks, I have focused on the six specific issues the Council enumerated in its charter for these hearings (see page 2 of Exhibit A) and have considered several perspectives, including that of regulators (such as the U.S. Department of Labor), participants and beneficiaries, plan sponsors and investment outsourcing firms.

My professional background is highlighted in Exhibit B.

An Executive Summary of my remarks is set forth in Exhibit C.

### ***Whether, Why and What to Outsource***

From the perspective of a plan's named fiduciary and sponsor, the rationale for whether, why and what to outsource may differ depending on several factors. These factors may affect the interests of the Labor Department, the outsourcing firm and the plan's participants and beneficiaries.

- *Whether the entire investment portfolio of an ERISA employee benefit plan is involved or only one or more portions of it.*

According to a survey released by ai-CIO magazine in February 2014, of those respondents that had implemented an investment outsourcing arrangement, less than half (48%) had outsourced the entire plan portfolio, i.e., 52% had outsourced only a portion of the portfolio. In my experience since 1977, named fiduciaries who outsource only a portion of the portfolio commonly delegate to an ERISA Section 3(38) "investment manager" responsibility over one or more categories of "alternative investments."<sup>2</sup>

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<sup>1</sup> "Outsourcing" in this context refers to transferring some part of the investment functions that named fiduciaries have typically themselves performed—most obviously, selecting, evaluating and periodically replacing underlying investment managers. However, as discussed here, "outsourcing" excludes the commonplace practice of named fiduciaries delegating authority to an ERISA Section 3(38) investment manager to manage a traditional publicly traded investment account. In short, outsourcing is more a "lateral" transfer than a top down delegation.

<sup>2</sup> "Alternative" investments include strategies and instruments other than long-only, traditional publicly traded equities and fixed income assets. "Liquid" or "marketable" alternatives include strategies and instruments that are publicly traded and at least moderately liquid, but involve nontraditional assets such as commodities, currencies and derivatives and/or involve techniques such as leverage and short selling. "Private" alternatives include strategies and instruments that are not liquid at the fund level and/or the underlying asset level, e.g., a limited partnership investing in private debt or equity. Fees for firms that manage marketable and private alternatives may include both base (or "management") fees and performance or incentive fees.

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The primary reason for transferring fiduciary responsibility over selecting particular alternative investment vehicles is that they are so complex, the regular named fiduciaries wish to engage a party with greater expertise for such investment decisions. With all alternative investments – such as a typical limited partnership investing in private market debt or equity – the named fiduciary may also wish to insulate itself from direct responsibility for selecting that particular vehicle. Insofar as a limited partnership’s assets are not ERISA “plan assets,” if the partnership fails, the named fiduciary will not have recourse under ERISA against the general partner; the latter is not a Section 3(38) investment manager. (Although traditional mutual funds likewise are not plan asset vehicles, named fiduciaries commonly are willing to invest directly in those because – unlike limited partnerships investing in alternative investments – they are regulated under the Investment Company Act and invest in conventional, publicly traded securities and strategies.) Rather than assuming direct fiduciary liability for evaluating and investing in a complex limited partnership, the named fiduciary may prefer to transfer that function to an outsourced fiduciary with the expertise to make the investment decision and which assumes the ERISA investment management liability for doing so.

- *When transferring responsibility over the entire investment portfolio, the sponsor’s reasons are typically a combination of the desire for greater expertise, speed, protection from liability and efficiency.*

The members of a single employer investment committee or a multiemployer board of trustees – regardless of how adept they are at their regular jobs – are typically not well-positioned to serve as institutional investment experts with named fiduciary responsibilities over an investment portfolio. They are typically not full-time institutional investment professionals, are typically very preoccupied with their primary employment responsibilities (e.g., as a company officer or union official), typically meet only quarterly and often require significant lead time for education before determining whether to commit plan assets to a particular investment or investment management firm.

- *Whether the regular named fiduciaries suffer a conflict of interest or prohibited transaction problem.*

In contrast to the preceding points – essentially revolving around prudence and liability – this point concerns potential party in interest considerations and fiduciary self-dealing under ERISA Sections 406(a)-(b). Such situations may arise across a wide range of circumstances, e.g., investing in employer securities, making an in-kind contribution (in lieu of cash), or a proposed transaction between a plan and a party in interest (e.g., distinct plans sponsored by the same company or labor organization). The proposed transaction may conceivably proceed either pursuant to a statutory exemption under Section 408(a), a class exemption (such as the QPAM exemption under PTE-C 84-14), or an individual exemption. In these situations, the named fiduciaries commonly either “allocate” responsibility over the proposed transaction to a co-named fiduciary under Section 402(a) of ERISA or “delegate” to the outsourced firm as an investment manager under Section 3(38). Generically, the role of the outsourced firm in either case is commonly called an “independent fiduciary.” See Exhibit D (“The Role of the Independent Fiduciary”). In all these situations, the reason the named fiduciary transfers responsibility to the outsourced firm is to overcome the potential conflict under Section 406(a)

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and/or (b) of ERISA and facilitate completing the proposed transaction, if the appointed independent fiduciary decides it is in the plan's interest.

- *What functions are outsourced.*

First, are functions that typically are outsourced; second, are those that are not; and finally, are those that may or may not be transferred but require clear delineation.

- In the case of outsourcing an entire investment portfolio, one essential function that is almost always transferred to the outsourcing firm<sup>3</sup> is exclusive discretion and responsibility over selecting and replacing underlying investment managers, along with related functions, such as portfolio transitions (mechanics surrounding terminating one manager and installing another), developing investment guidelines over separately managed accounts (as a matter of risk control) and rebalancing the portfolio among managers and asset classes relative to long-term or “strategic” targets, including raising necessary cash.<sup>4</sup>
- Second, are functions that – at least in my experience – are typically (with some exceptions) not outsourced. These include higher level policy matters, such as adopting or amending an investment policy statement for the plan's overall investment program and an asset allocation consistent with that policy. The reason the named fiduciary typically retains responsibility over these matters is that they are integrally related to the enterprise risk and objectives of the plan sponsor per se and are ultimately very judgmental, policy-driven issues, e.g., the investment objectives and types and degrees of risk that the named fiduciary (and the plan sponsor as the appointing party) desires or finds acceptable. These are not matters a third party is typically in a position to decide.

Beyond these two most fundamental categories – manager selection and investment policy/asset allocation – are other refinements which the parties may not clearly address; and **yet identifying and reaching explicit agreement on these points is strongly advisable for clarity in roles and responsibilities – clarity in governance of the investment program.** In contrast to asset allocation, “portfolio structure” and “manager structure” are typically transferred to the OCIO firm because they are sufficiently related to manager selection. (Portfolio structure refers to dimensions such as use of active versus passive strategies, or concentrated accounts vs. broadly diversified ones. Manager structure refers to dimensions such as the number of investment managers, the types of accounts (e.g., separately managed versus mutual funds versus commingled funds)). However, even with these points addressed, the parties should address and agree upon other refinements as well. For instance, who is responsible – the named fiduciary or the OCIO firm – for determining whether and to what extent various types of instruments and strategies are permissible, e.g., use of derivatives (exchange traded and/or over the counter), types and degrees of leverage and short selling, to name just a few? These may be deemed

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<sup>3</sup>In this context, the outsourcing firm is commonly called an “Outsourced Chief Investment Officer” or “OCIO.”

<sup>4</sup>In some OCIO arrangements, the OCIO is designated an ERISA Section 3(38) investment manager and the named fiduciary “delegates” responsibility to it. However, I believe a preferable arrangement is for the regular named fiduciary to “allocate” specified investment responsibilities to the OCIO as a co-named fiduciary pursuant to Section 402(a). Named fiduciaries are clearly empowered to, in turn, “delegate” investment management responsibility to underlying firms under Section 3(38).

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suitable for the investment policy statement or perhaps as aspects of portfolio structure; the parties should resolve this.

Other functions that the parties should address include, e.g., responsibility for evaluating and making discretionary decisions for the ERISA plan regarding:

- Custody – who selects and is responsible for evaluating the functions, fees and performance of the custody bank.
- Brokerage and transactions costs – this is typically part and parcel of manager selection and thus, commonly outsourced. Quite distinct, however, is whether the OCIO also agrees to provide (for no extra fee or commissions) brokerage for any underlying investment managers who choose to use its affiliated broker-dealer. This raises significant issues under Sections 406(a)-(b) for both the OCIO and the named fiduciaries responsible for monitoring it.
- Investment consulting functions – this operates on two levels. First is investment consulting concerning functions that the named fiduciary retains for itself, e.g., developing and adopting the plan’s investment policy statement and asset allocation. A common arrangement is that the named fiduciary selects one firm both to advise it as a nondiscretionary investment consultant regarding investment policy and asset allocation and – when it comes to functions such as manager selection – to act as the discretionary OCIO. As a matter of contractual draftsmanship, a relatively straightforward way of structuring this is through a scope of work that distinguishes between the nondiscretionary subjects and functions the firm will perform as investment consultant versus the discretionary subjects and functions it will perform.<sup>5</sup>

The second level of investment consulting is the named fiduciary’s ongoing duty to evaluate the performance of the outsourcing firm. In that regard, the named fiduciary commonly engages another firm solely as an investment consultant to assist it expertly and impartially in evaluating the outsourced fiduciary’s discretionary performance, as discussed more fully below.

### ***Key Variables in Selecting an Outsourcing Firm***

Time and space do not allow a detailed discussion of this complex topic, but a brief set of bullet points may help the Advisory Council. Key variables the named fiduciary should consider include:

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<sup>5</sup> Transferring the manager selection function to an OCIO takes different forms in a defined benefit pension fund or a welfare fund (such as a VEBA) compared to a participant-directed defined contribution plan. In the former, the named fiduciary commonly transfers to the OCIO responsibility over selecting, funding and rebalancing among underlying investment managers and investment vehicles across all or part of the portfolio. However, with a participant-directed defined contribution plan, the named fiduciary commonly transfers only responsibility over selecting and periodically replacing the particular investment funds offered on the plan’s “menu,” from which participants then select whether and how much of their own assets to invest.

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- The nature of the firm, e.g., an investment consulting firm, a multi-asset class investment management firm, an investment bank/broker dealer, or a firm formed to act as a “manager of managers.”
  - Business model. Related to the nature of the firm, this also includes, for instance, whether the firm offers its own investment funds and – if it does – whether it invests client assets only in those funds or whether – by contrast – it employs an “open architecture.”
  - Experience with outsourcing. According to the recent ai-CIO survey, the length of the firm’s history as an OCIO is a very significant factor to many ERISA plan fiduciaries considering whether and to whom to outsource.
  - Conflicts of interest. OCIO firms with affiliates engaged in asset management, retail financial advice, investment banking and/or broker-dealer activities may present complex issues for both the OCIO and ERISA named fiduciaries under the prohibited transaction and fiduciary self-dealing provisions of Section 406(a)-(b).
  - Fees. One model is the plan client pays the OCIO an “all inclusive” fee, which covers all functions outsourced, as well as the fees of underlying investment managers. In this model, the client pays a single amount to the OCIO, the OCIO negotiates (presumably lower) fees with the underlying managers and the OCIO keeps the spread. The client may or may not know the amount of that spread. Another model is the plan client pays the OCIO only a fee for the functions it performs, and separately pays a distinct, fully transparent fee (which the OCIO negotiates) to each underlying manager. The formula and level of the fee is another consideration, e.g., whether the OCIO charges a flat, hard dollar fee; whether it charges in terms of basis points relative to the fair market value of the portfolio it controls; and whether it also collects any form of soft dollars or indirect compensation (which may raise issues under Sections 406 and may entail complicated reporting under Section 408(b)(2) disclosure regulations).
  - Investment track record. This is tricky, because many outsourcing firms have limited history. Also, simply comparing the nominal, consolidated investment returns of any candidate’s clientele is not indicative of the firm’s acumen; the nature, funded status and investment policy of each of its clients typically and justifiably will dictate the investment program – and risk/return results – for each. A more useful inquiry is to examine the returns different candidates have historically achieved asset class by asset class (or subclass by subclass), e.g., domestic large capitalization equities, domestic investment grade fixed income, etc. Even with this approach, however, the definition of each asset class or subclass requires great care in order to arrive at valid comparisons. An additional challenge in comparing returns is the absence of a governing body or set of rules for determining which portfolios a candidate should (or should not) included in an asset class composite. (By comparison, the CFA Institute standards govern performance computations and performance reporting for composite returns of investment managers.)

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## ***What the Plan Sponsor/Named Fiduciary Should Monitor and Evaluate***

Even when it outsources considerable investment discretion, the plan's named fiduciary remains responsible for prudently monitoring:

- The performance of the OCIO and thus, whether to continue retaining it or replace it with another firm. As discussed below, evaluating investment performance requires appropriate benchmarks and performance attribution.
- The structure or “architecture” of the arrangement. In other words, even if the OCIO is performing well in some respects, experience over time may suggest changing the nature of the engagement. One example is changing the structure or level of the fees. Another example is that the named fiduciary may initially grant the OCIO full discretion to determine the proper balance between active and passive asset management. Over time, however, prudent monitoring and analysis may demonstrate that the OCIO has not added value through selecting active managers for particular categories of assets (e.g., for large cap domestic stocks); and thus, the named fiduciary may keep that OCIO in place, but, going forward, require only passive management for that asset subclass.

**In my experience, many named fiduciaries do not clearly understand that they remain responsible both for a range of duties they have not transferred to the OCIO and for prudently evaluating the OCIO's performance concerning what they have transferred. Nor do many named fiduciaries clearly understand what “prudently evaluating the OCIO's performance” entails.** One way of addressing this problem is care in drafting the contract for the OCIO, e.g., clarifying what is and isn't transferred, as discussed earlier. Another way of addressing this problem is through thoughtfully analyzing and evaluating the investment results the OCIO achieves – what investment consultants call “performance attribution.”

Performance attribution is the process of analyzing the underlying “drivers” or nature of the investment decisions that produce a portfolio's investment returns.<sup>6</sup> For instance, one way the OCIO may add – or subtract – investment value is by its selection of underlying active investment managers, including the extent of active vs. passive management. Another way is its asset allocation decisions, including how much to overweight or underweight a particular asset class relative to its strategic target, e.g., if the long-term target for domestic stocks is 50%, plus or minus 5%, and in a raging equity market the OCIO overweights that part of the overall portfolio (say, to the full 55% maximum), that may add to returns. Another example – if the OCIO has discretion over how to structure broad asset classes – is how it chooses to do so, e.g., investing a portion of domestic stocks in small cap stocks and if so, how much.

In short, to intelligently critique its OCIO and the structure of its arrangement with that firm, the named fiduciaries may engage an investment consulting firm to help with performance attribution and evaluation.

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<sup>6</sup> A fuller explanation of this type of performance attribution is included at Exhibit E, an excerpt from a chapter I authored from a book on pension fund investment programs, published by the World Bank, entitled Governance and Investment of Public Pension Assets—Practitioners' Perspectives.



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Another aspect of monitoring may arise from the nature, business model and fee structure of the OCIO. For instance, if the firm provides brokerage for the plan's investment managers – whether for additional compensation or as part of its all-inclusive fee as OCIO – that may well entail disclosure obligations for the OCIO and significant issues for the named fiduciaries to understand and evaluate.

## ***Conclusion***

Ultimately, the key to a successful OCIO engagement is clearly delineated rules of engagement, established up front – providing clarity regarding who is responsible for what, including how the OCIO will be monitored and measured. The named fiduciary will normally retain control and responsibility over setting objectives, documented in the investment policy statement. However, the named fiduciary may outsource portfolio structure and implementation (both in terms of manager selection as well as investment guidelines). The named fiduciary retains responsibility to ensure that the OCIO is suitably qualified and providing services consistent with expectations. The key value proposition of the OCIO relationship is to facilitate expert, timely implementation within the framework established between the named fiduciary and OCIO.

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